DOW THEORY LETTERS INC.

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January 16, 1976 Letter 653

WHERE I WENT WRONG: I know that this title is not the kind of thing one ordinarily expects to see in an advisory, but I'm not in the business of trying to look good, nor am I in the business of covering my tracks with a bunch of gobbledy-gook. The fact is that from the end of November through December I felt that the market looked shaky. I did not think the various indicators were getting in gear properly, and I thought there were enough "danger signs" to warrant a conservative market stance or even a position on the sidelines.

Personally, I hate to make mistakes about the market, but I dislike even more the oft-practiced policy of making mistakes and then pretending they never happened. Mistakes are there for us to learn by. I've made them before, and I'll make them again. But the important thing to me is that I learn from my mistakes, and that my subscribers also learn from them. I've often stated that I've learned more studying other advisors' mistakes than I've learned from watching their successes. I suppose one reason that is true is that I relate intensely to how people go wrong in the market (having gone wrong so many times myself over the past 25 years).

Dostoievski, in one of his darker moments, wrote that "there never was a crime that I couldn't conceive of committing myself." I apply the same thought to this business. There never was a mistake made in the market that I couldn't imagine making myself.

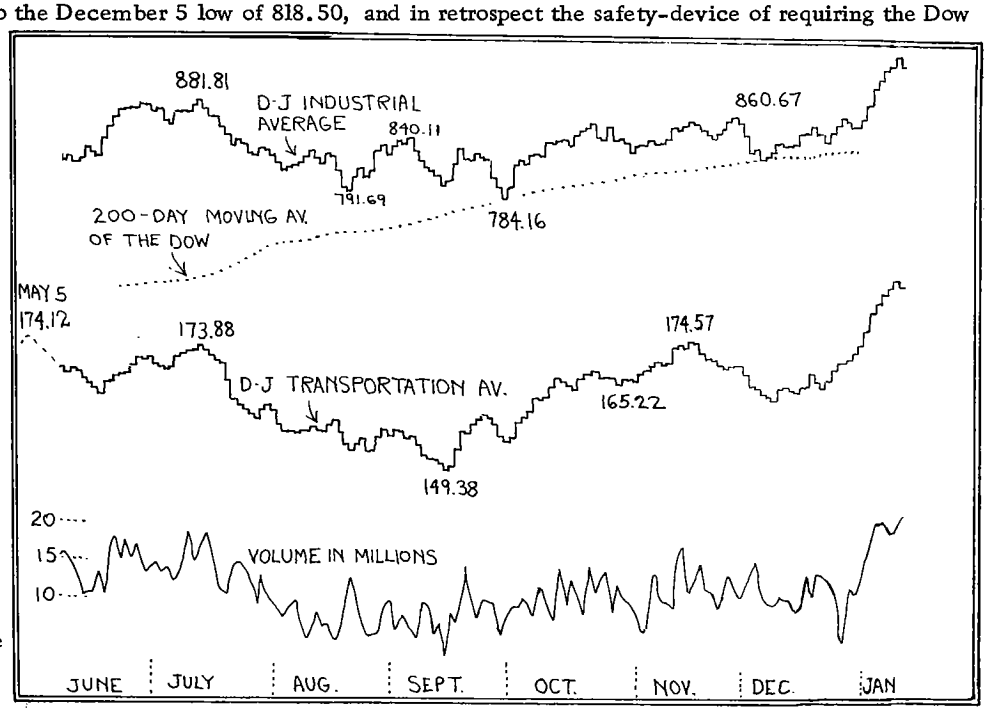
As I look back on the November-December market performance, this is what I think I did wrong. I wrote that "credence must always be given to the direction of the primary trend." I wrote that in almost every Letter, but then I did not give sufficient credence to the primary trend myself. In practice, if you are in a primary bull market (which we are certainly now in) it is always best during a corrective period to maintain a fairly skeptical attitude towards the downside. By that I mean that you should make the market prove that the trend is turning down.

Let's go back and look at some concrete examples of this axiom. On November 28, when Transports failed to confirm the secondary peak recorded by Industrials, the "double non-confirmation" of which I had written was completed. Such structures have occurred many times in the past, and when they did the result was always substantially lower prices. But here was a double non-confirmation occurring in a primary bull market which was only 13 months old. The situation at the time appeared ominous, I issued my warning Letter, and almost simultaneously the market broke down.

In retrospect, I should have allowed the downtrend to prove itself by requiring the Industrial Average to plunge below its 200-day moving average (see chart on page 1). The 200-day MA is always useful as a gauge of the severity of corrections. Furthermore, the 200-day MA had already contained the Dow on the reaction to the October 1 low. Ironically, the 200-day MA perfectly contained the Dow on the drop to the December 5 low of 818.50, and in retrospect the safety-device of requiring the Dow to break below its 200-day MA would have kept all our long positions intact.

A second safety-device would have been requiring the CMAS (see chart) to drop below its September low or even to require the A-D ratio to break below its own September low.

There are a number of other phenomena which I might have resorted to before advising extreme caution, but it is the device of timing that I feel most frustrated about. I had written repeatedly that the "last joint lows of the reaction" had occurred in September (the Transports never broke below their 149.38 September low), and that the longer the elapsed time without new lows, the greater the pressure on the bears. During a bull market, time is always on the side of the bulls, and



by the time December rolled around it had been three months since the last confirmed lows. Time was indeed running out for a resumption of the reaction, and although I was aware of this I obviously did not stress it enough, nor did I keep it constantly in mind.

So in view of all this, I ask myself (as I've asked myself for 18 years), why do people in increasing numbers read this service? I don't offer perfection, I do miss some good moves, I make mistakes, I frustrate myself at times and I frustrate my readers at other times. "Do they read me as literature," I muse, "or as fiction, as an ongoing series of 'confessions of a stock market advisor,' the rantings of a West Coast nut, or all of these?"

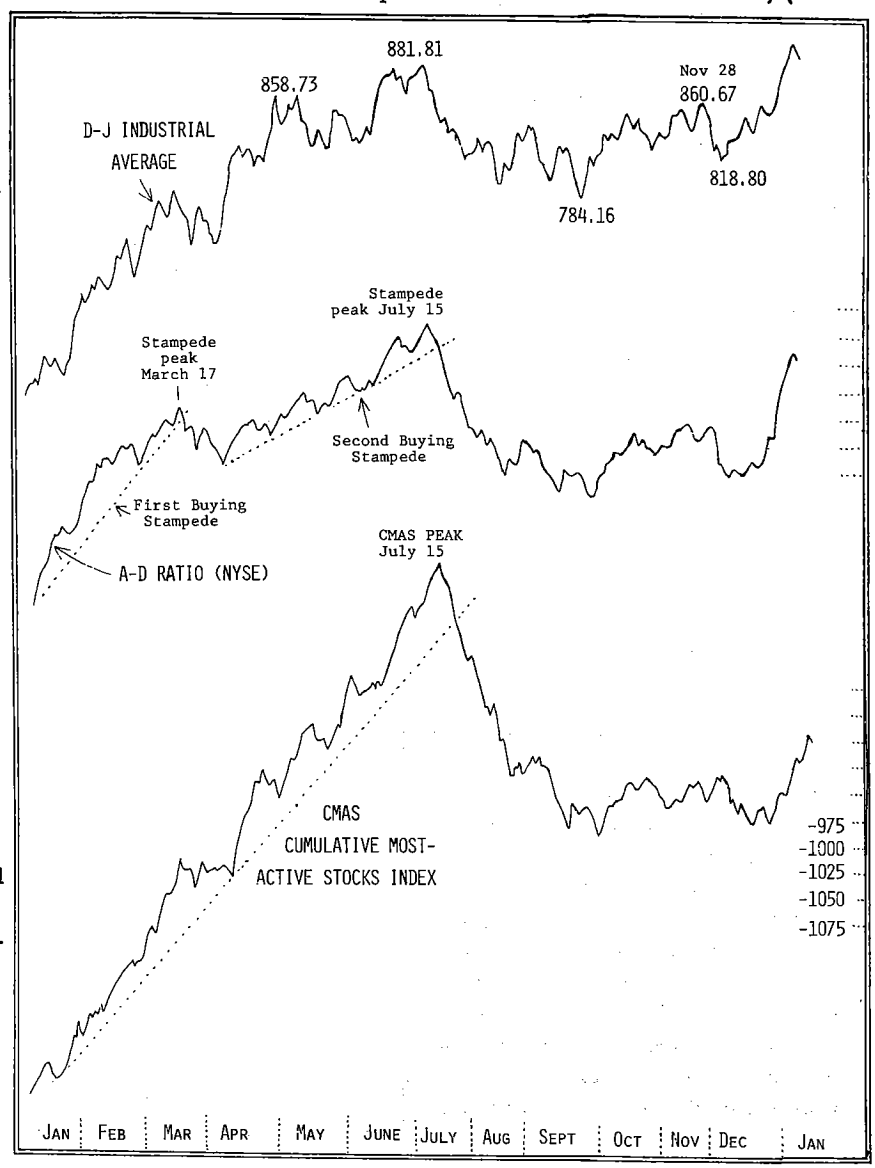
My own guess is that people read these reports because in reality I am wrestling with the same things they are wrestling with: What are stocks going to do, what is the economy going to do, what do I do with my money, does the whole Wall Street scene really make sense, and if it does can I take away more money from it than I put into it?

Actually, I suspect people read these reports because we are all in a learning process together. We learn through pain and we learn through frustration, but the important thing is that we learn. And that's why I want to review and analyze my mistakes. The good things we do in this world take care of themselves; it's the mistakes that we can potentially learn most from.

WHAT HAVE WE HERE? Argue with it, complain about it, distrust it, do anything you like, but be aware that if you're fighting this bull market, you're spitting into the wind. The fact is that the bull market "came alive" on December 31, and by January 7 all three D-J Averages, Industrials, Transports and Utilities were at new highs for this bull market. They were at new highs together, something we haven't seen in eight months or since May, 1975.

Not only were stocks strong, but the bond market has put on a sensational performance. Those subscribers who have been holding the 7-3/4 Treasury Notes of 1981 (which were recommended here earlier) have now seen these notes rally from just above 96 (September, 1975) to last week's peak of almost 102. The D-J 40-Bond Average has also been in powerful upsweep, and as of last week the 40-Bonds had rallied to a new high for the year. The importance (and necessity) of an ongoing strong bond market was discussed in the last Letter.

As far as the Averages are concerned, we have a situation in which Industrials and Transports have climbed almost vertically (on huge volume) since late-December. This is very reminiscent of the action in late-January, 1975, just after the original primary bull market signal.



Glancing over the page 1 chart, we now know the secret which the market has hidden from us since last July. The secret: Informed money has been accumulating in the face of the worries about an economic downturn, in the face of warnings about higher interest rates, and in the face of a thousand other worries.

As far as Dow Theorists are concerned, the market has spoken and the verdict is in. The January 5 Industrial closing (above 881.81) confirmed the previous new Transport high, and for the first time since May, 1975, both D-J Averages moved to new bull market highs. This was the market's way of saying that it's a "green light" as far ahead as it is possible for Wall Street to see. The Averages, by moving to new recovery highs, were announcing that "it's still a bull market, it's a re-confirmed primary bull market, and the path of least resistence for stocks and the economy is up."

All right, you reply, but how about the advance decline ratio and the new highs? How about the fact that the A-D ratio and most stocks are still below their top-out peaks of last July? How about the fact that the unweighted averages and the NYSE Industrial Average are still below their 1975 peaks? How does this fit in with the D-J Industrial and Transport Averages proclaiming that it is a re-confirmed primary bull market?

My answer is as follows: The A-D ratio has moved into what could be the first "buying stampede" of 1976. The A-D ratio (see chart) is currently up over

4 points and anything over 5 points (without an intervening 1 point correction) qualifies as a buying stampede. It is true that many of the widely-followed Averages are not at new bull market recovery highs, but I consider this a good omen for current and potential buyers, because it means that stocks could have a long way to go on this second advancing phase of the bull market.

It is probably true that the mass of NYSE stocks (as measured by the A-D ratio and the unweighted stock averages) will find it tougher going than will the thirty corporate giants that make up the D-J Industrial Average. But if the January 5 verdict of the Averages is correct, if business and the economy are fated to improve through 1976, then in due time the prosperity is going to rub off on the great majority of NYSE companies, and the A-D ratio and the unweighted averages will reflect that improvement by pushing to new bull market highs.

It is well to remember that "Rome wasn't built in a day," and a primary bull market isn't built in a few weeks or a few months. With the primary trend reconfirmed as bullish, time is still working in favor of higher prices, and I believe it is only a matter of time before "almost everything" moves above the July, 1975 highs.

Incidentally, I note that there are still a number of respected market analysts that are claiming that this is "just a massive reaction in a continuing primary bear market." I have argued against this line of reasoning ever since January, 1975. I don't know what will convince these gentlemen that we are in a primary bull market — probably nothing will. You can call a four-footed animal with all the bovine characteristics a duck or a butterfly, but that still doesn't negate the fact that he is a bull. And you can call this re-confirmed bull market a bear market rally or an upside abberation, but it still acts like, looks like, and feels like a bull market. What profit or comfort anyone can obtain from labeling black as white or up as down I don't know. It's probably just a lesson for us all in human stubborness.

PHASES: It has been some time since I've discussed the three psychological phases (not to be confused with price movements) of a primary bull market. Yet, an understanding of the phases is crucial, and this should be a good time to review the subject while relating the phases to the current market action.

Phase one of a bull market represents the rebound from the depressed and undervalued levels of the previous bear market lows. I reviewed the late-1974 situation in many previous reports. That was a period when stocks were selling at great values, or as I put it at the time, stocks were selling below known values. The P/E ratio for the Dow was 6, and the Dow Industrial Average was priced under book value. That was a situation which had not been seen since 1949 (and even in 1949, P/E ratios for the Dow never got below 7). Thus, late-1974 was identified as an important bear market bottom, and the great upward swing from October-December, 1974 to July, 1975 constituted the first phase of the new primary bull market.

Following the July, 1975 peak, we witnessed the typical correction that so often separates the phases of a bull market. The correction carried from July to September-October. It was then that the bull market enetered its second psychological phase.

It is well to note that the second phase of a bull market has fairly definite characteristics. It is usually (but not always) the longest phase. It is usually the most deceptive phase. It is the phase in which the market discounts a gradual but discernible improvement in business and the economy. It is the phase which is accompanied by the gradual entrance of the public. And finally, the second phase is characterized by one or more severe and very tricky (scary) secondary reactions.

As I interpret the situation, the second phase of this bull market is now in the process of unfolding. There is no way that I or anyone else can predict the ultimate length or duration of the second phase which is now underway. It could carry to mid-1976 or it could extend well into 1977. It could top out with the Dow at 975 or it could take the Dow to 1400. No one, and I repeat no one, can possibly know. It is difficult enough trying to identify a top area in a bull market, but it is almost impossible (and an exercise in sheer nonsense) to try to predict the top.

We do have a few guides at this time however. First, we know that the second phase of a primary bull market is usually longer than the first phase, (often considerably longer). Since the first phase of this bull market lasted around 7 months, it would not be surprising to see this second phase last around twice as long or even longer. If the second phase remains in force for 14 months, we could expect it to carry (starting from September, 1975) through the end of 1976 or even into 1977.

Next, the force of the January 5 breakout (force from both the volume and price movement standpoint) suggest a strong and persistent (major) upside move. The fact that public participation has been absent, so far, also suggests that the upward move could carry considerable distance in both duration and extent. It is also well to remember that the second phase of a bull market may contain many severe and deceptive corrections, but these corrections may not necessarily end the phase. For instance, the second phase of the 1949-66 bull market saw violent corrections during 1956 and '57 which resulted in the majority of Wall Street shouting "bear market." All of which proved to be a giant deception.

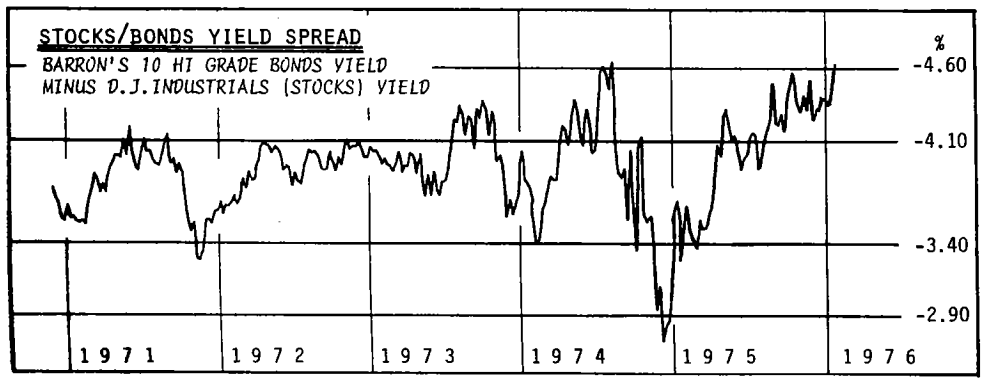
Following wherever this second phase ends, we will go into the third or final phase of the bull market. The third phase should see the wholesale entrance of the public, it should see the greatest speculation, and it should see the heaviest volume. But we will go into third phase characteristics further when the time is more appropriate.

NEAR-TERM: Each bull (or bear) market develops its own characteristics. This bull market is no exception. So far, this has been a very "institutional" market in that it is dominated by big money, pension money, and institutional money (around 70% of all trading on the NYSE is now coming from institutional sources).

So far this market has been "operating" on the basis of extended consolidations and then buying stampedes (or near-buying stampedes) as the market moves out of the consolidation-accumulation areas. The buying stampedes have been accompanied by massive volume. Examples of the consolidation-accumulation phases are September-December, 1974 and July-December, 1975. The stampede phase was seen during January to May, 1975. Interestingly, the rise from the December 5 low to the present has taken the A-D ratio up about 4.5 points, so that as of January 12 we were just short of qualifying for a 1976 buying stampede.

From the standpoint of market action, it is well to realize that very high volume advances tend to breed more violent declines than do low volume advances. This is because high volume attracts concentrated buying as well as profit taking and selling. On the other hand, low volume rises (because they often appear questionable) often last longer because all the buying is not concentrated into a week or a few weeks' enthusiastic upside action.

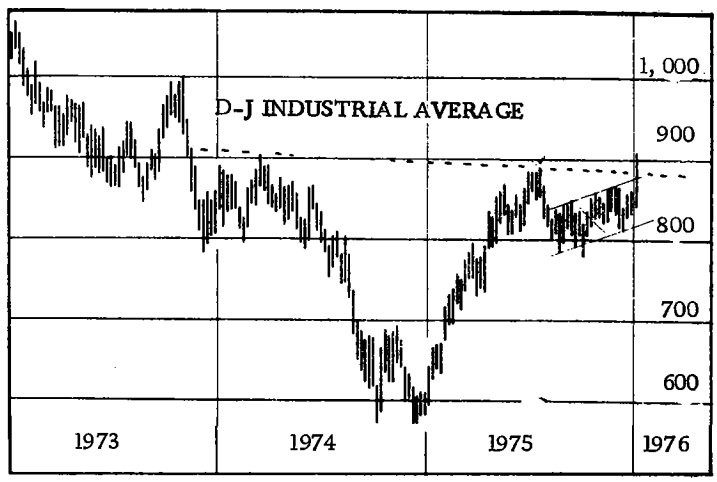
Over the past week NYSE volume has been of record-breaking proportions. January 13 saw the first downside action of 1976, a 9 point Dow drop amid a churning 34 million shares of volume. This was immediately followed by a new wave of buying (January 14). At this point it is too early to tell whether the huge volume of early January will materialize into a temporary "resting point" or minor top for the market, but it is well to remember that corrections in bull markets tend to be very rapid and violent, often wiping out in a few days the upside progress of weeks.



In my opinion, the single greatest problem for the market now is the yield spread between stocks and bonds. In the last Letter I included a chart of the negative yield spread between the Dow and Barron's 10 Hi-Grade Bonds. This week the negative spread (see chart) moved over 4.6%, almost a record. To me, this means that the Dow is getting ahead of itself in terms of the bond market, or to put it another way, it means there is an element of real strain. From this standpoint, a correction would be helpful in that it would move the yield spread back into a more tenable area.

But regardless of yield aberrations or any temporary downside action from here, the market appears to be in a strong uptrend. A correction here would probably be rather minor, and would simply serve to let some steam out of the Wall Street boiler, while cooling the ardor of eager (should I say greedy) traders.

"HEAD-AND-SHOULDERS" PATTERN: Of particular current interest is a pattern which I brought to the attention of readers in Letter 645, page 6. This is the massive head-and-shoulders bottom pattern formed by the area of early 1974 (the left shoulder, see chart), the area of the late 1974 lows (the head), and the area of mid to late 1975 (the right shoulder).



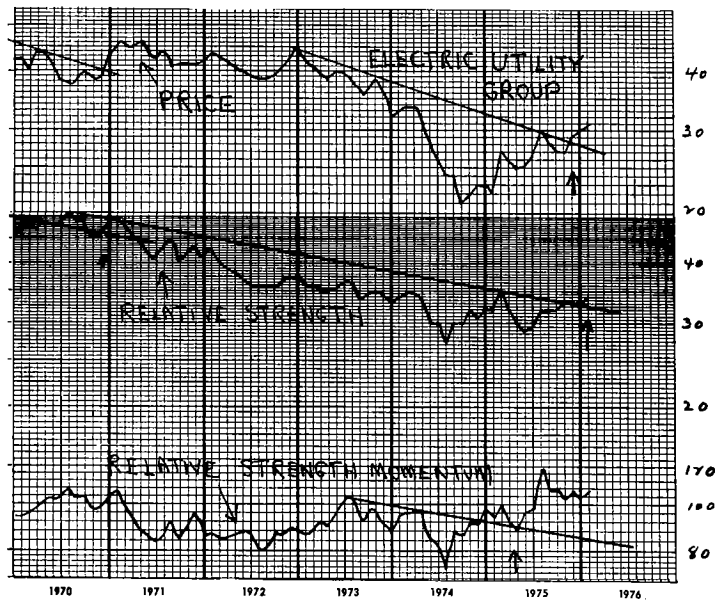
We now know that all this preparatory action completed a giant base which has taken the form of a completed "head-and-shoulder bottom." I have shown the old resistence line on the accompanying chart (dotted line), and of course, once the Dow has rallied above the resistence that same line becomes one of support.

Classically, the measurement for a completed move (from a H & S bottom) is a projected distance at least equal to the distance from the bottom to the resistence, this distance to be measured from the resistence upward to the final projected top. On such a reading, the Dow could go well over the 1200 area before this bull market is over. It should be remembered that projections of this sort do not always work out, nor are they something you can rely on. But they are one of the few technical gauges we have that can be used for measuring the potential for a move. For that reason, I included the "over 1200 projection" in this report.

TECHNICAL NOTES: The negative volume index (NV), discussed in the last report, has now developed a most bullish profile, more bullish, in fact, than at any time since the explosive first quarter of 1975. I would hope that NV will continue to support the market as we move further into 1976, and if so we could get a much broader move than we saw for the year 1975 as a whole. The NV index turned down in April last year, and this action was followed by a reactionary-consolidation phase which lasted literally from May until the end of the year.

My weekly most-active stock index (three week moving average) rose to plus 49 on the week ending January 5. This is the highest figure of which I have any record. Certainly it represents a most powerful send-off for the market as it breaks out above the July-December trading range. The index is tabulated from the 20 most active stocks (for the week) as published in Barron's.

STOCKS: The accompanying chart is probably the most important relative strength chart of the past few months (chart courtesy of Ray*Signals, 43 Lake Ave., Montrose PA 18801). What we see here is the January, 1976 upside breakout in relative strength (RS) for the Electric Utilities. As of January, the Electric Utility group has turned up on a trend basis (top line), the RS of the group has turned up on a trend basis and the momentum of the RS (six months rate of change) is also in a bullish trend. Thus the Utilities have given an important bull signal.

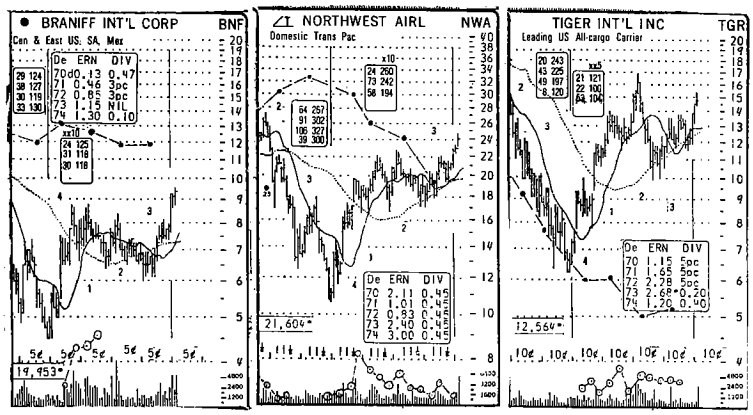


What is so important about this signal is (1) that the Utilities tend to be a bellwether indicator for the entire stock market, (2) the Utilities represent an enormous factor in the US economic structure, and the market is now saying "green light" for the Utilities, (3) the Utilities are strongly influenced by money rates, and the bull signal in Utilities bodes well for interest rates, and (4) the RS line has turned up for Utilities after a decline of over five years! As a rule, the longer the RS decline in a group, the greater the upward potential once the RS line signals a reversal to the upside (i.e., a bull signal).

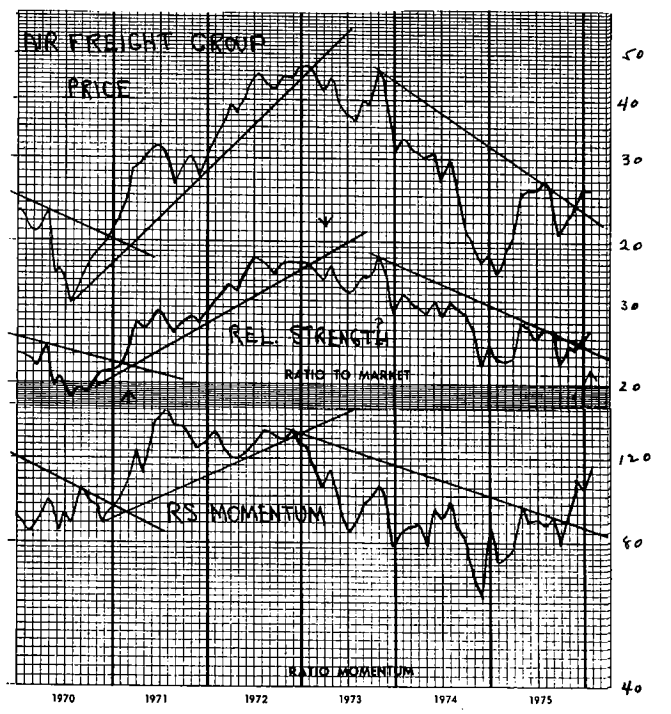
I have been writing about the big potential bull market in bonds. Letters 640 and 644 discussed the bullish double bottom (1970 and 1974) in the D-J 40 Bond Average. Based on what I considered to be a coming major rise and bull market in bonds, I have repeatedly recommended Treasury notes, high grade-bonds, Utility stocks (common and preferreds) and closed-end bond funds. Letters 645, 648 and 652 recommended Utility issues.

With the current breakout of RS in the Utility group, I again recommend the bond-funds and the Utility issues (both common and preferred). The Utility Average topped out in 1965 at 165. By late 1974 the Average had fallen to 57. Currently the Utility Average is back to around 87, and this represents a recoup of 27% of the 1965 to 1974 losses. I believe we are going to see a lot greater percentage return before this bull market is over.

Any broker should be able to provide you with a good list of attractive yielding Utility commons and preferreds. I continue to think they are on the bargain table at this time. Note: many of the very high yielding but lesser quality Utility commons can now be considered in the light of the "all clear" signal rendered by Utility RS.



RELATIVE STRENGTH CHANGES: Upside reversals (according to the monthly Ray*Signals chart for January) were Electric Utilities (discussed already) and Air Freight. Air Freight includes Emery, Seaboard World Airlines and Tiger Int'l. Of the three, I like Tiger best. The weekly chart shows an interesting pattern for TGR with the stock now moving strongly above its 200-day MA. RS trends usually last for at least a year or so, and I would expect a fairly good recovery from the RS decline in this group which lasted from 1973 through most of 1975 (Air Freight group chart courtesy of Ray*Signals).



In Letter 650 I noted that the Air Transport group had moved strongly to a plus reading in relative strength. This strength in airlines gave the Transport Average a big boost, and that in turn fired the whole market. Northwest and Braniff would be my choices in this group. Of interest to institutional investors is the fact that IBM has now turned bullish on a RS basis — after a RS decline lasting almost three years.

SPECULATIVE ISSUES: Back in 1958, during the 1949-66 bull market, I recommended many speculative issues to be purchased and "put away" for the latter part of the second phase but more importantly for the speculative third phase of the bull market. Many of those issues did extraordinarily well during the late 1950's and 1960's as the public finally came into the bull market full force.

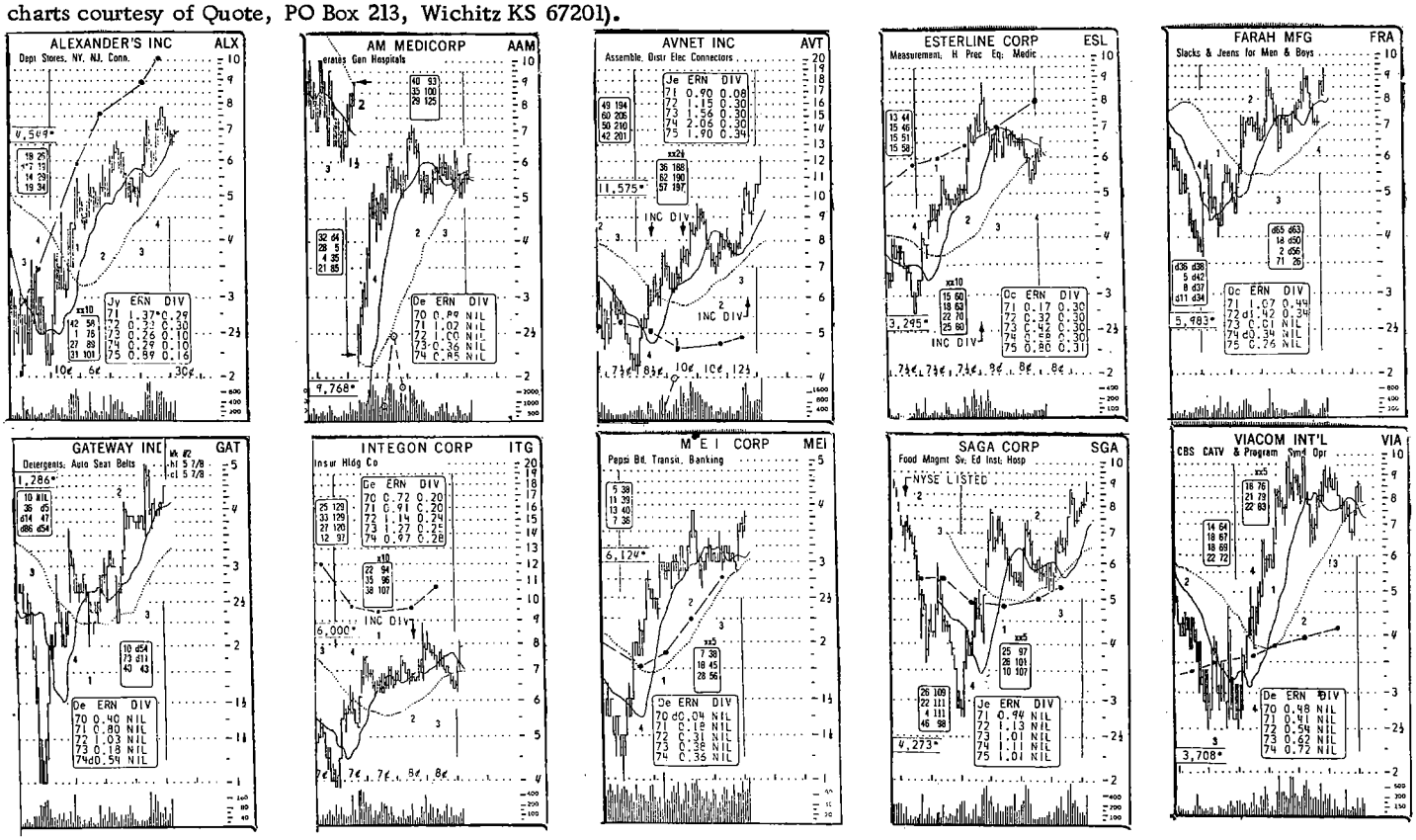
At this point, I feel that a "collection" of low-priced stocks will be worth accumulating. These stocks may be considered as a sort of ultimate call on the bull market, and I say this because these are the kind of issues that the public will want when the going gets frothy.

I have picked these stocks as follows: (1) all are listed on the NYSE. (2) All are rated #1 by the excellent Value Line service, and this is Value Line's highest classification for performance potential during the coming year (the stocks are mostly speculative and many are in Value Line's lowest classification for safety. (3) All of these stocks are around 10 or below in price, and I therefore consider them low-priced issues. (4) I have tried to pick stocks which are in groups showing superior relative strength.

It is important that any subscriber wishing to go into this kind of long-term speculative venture (1) do some research on his own regarding the issues he picks, and (2) purchase an assortment of preferably 7 to 10 or more different issues. By diversifying, the buyer allows the primary bull trend to work for him. My experience tells me that it is almost impossible to pick the two or three big winners out of say ten issues. But on balance any 10 of these stocks should show good appreciation before this bull market has breathed its last.

Here is the list. Alexander's Inc., American Medicorp, American Seating, Automation Ind., Inc., Avnet, Esterline, Farah, Gateway Ind., General Host, Helene Curtis, Hydrometals, Integon Corp., MEI Corp, Milton Bradley, Saga Corp., Viacom. Three closed-end funds in the #1 under $10 group are: Advance Investors, Madison Fund, US & Foreign Securities.

A few other stocks I feel are worth adding to the list (these are not in Value Line's 1-rated list) are: Adams Drugs, Addressograph, American Medical Int., Braniff Int'l, Cluett Peabody, Cooper Tire, Transamerica. All this list sells under the $10 level, thereby allowing for a good deal of speculation if, as, and when the public starts combing the NYSE lists for "bargains." (Small charts courtesy of Quote, PO Box 213, Wichitz KS 67201).



GOLD: The bear market in gold and gold shares continues. With bullion breaking the 136 support level, the test has now moved down to the critical 128 bear market low. If bullion holds 128, we may be at or near the bottom. Breaking 128 with force will probably send bullion heading for 115. The S. African stocks have no bases yet, just long downward plunges out of massive tops formed in 1974-75. Homestake, best acting of the gold equities, is diversifying out of gold and is becoming a natural resource stock, (lead, zinc, uranium, forest products). Is the HM management unwittingly telling goldphiles something? Next Mailing: January 28.